COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC REQUEST OF ATMOS ENERGY CORPORATION FOR MODIFICATION AND EXTENSION OF ITS GAS COST ADJUSTMENT PERFORMANCE BASED RATEMAKING MECHANISM	)))))	CASE NO. 2020-00289

O R D E R

On August 31, 2020, Atmos Energy Corporation (Atmos) filed a report describing the performance of its existing Performance Based Ratemaking (PBR) mechanism and a motion requesting that its PBR mechanism be extended, without modification, for five years through May 31, 2026. On October 2, 2020, the Commission granted a motion to intervene filed by the Attorney General of the Commonwealth of Kentucky, by and through the Office of Rate Intervention (Attorney General), and on October 19, 2020, the Commission issued an Order establishing a procedural schedule for this matter. Atmos responded to requests for information from Commission Staff and the Attorney General, and a hearing was conducted on January 27, 2022. Atmos and the Attorney General have submitted briefs in support of their positions. This case is now before the Commission for a decision on the merits.

BACKGROUND

The Commission approved Atmos' current PBR mechanism in Case No. 2015-00298 through May 31, 2021.[1] Atmos' PBR mechanism is broken into three parts—the

[1] Case No. 2015-00298, *Request of Atmos Energy Corporation for Modification and Extension of its Gas Cost Adjustment Performance Based Ratemaking Mechanism* (Ky. PSC Mar. 31, 2016), Order.

Gas Acquisition Index Factor (GAIF), the Transportation Index Factor (TIF), and the Off-System Sales Index Factor (OSSIF).[2] Atmos' GAIF is broken into three component parts—the GAIFBL measures base load gas costs against benchmarks, the GAIFSL measures swing load system supply costs against benchmarks, and the GAIFAM measures fixed discounts provided by the supplier for asset management rights, if any, not directly tied to per unit natural gas purchases.[3] The TIF component of Atmos' PBR mechanism is calculated by determining the difference between the benchmark demand and volumetric gas transportation costs and the actual demand and transportation costs.[4] The OSSIF in Atmos' PBR is simply the Net Revenue from Off-System Sales, which is calculated by taking the total revenue associated with off-system sales and storage service transactions and subtracting the out-of-pocket costs associated with off-system sales and storage transactions.[5]

For base load purchases within monthly firm commitments, GAIFBL benchmarks the cost of base load purchases against the average Inside FERC – Gas Market Report first-of-the-month posting for the area index associated the zones in which Atmos has firm transportation commitments and the New York Mercantile Exchange (NYMEX) Settled Closing Price.[6] For purchases in excess of firm monthly commitments, GAIFBL

[2] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 18.

[3] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 19.

[4] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 26 – P.S.C. KY No. 2, First Revised Sheet No. 27.

[5] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 27 – P.S.C. KY No. 2, First Revised Sheet No. 28.

[6] Atmos' Gas Tariff, P.S.C. KY No. 19, First Revised Sheet No. 26 – P.S.C. KY No. 2, First Revised Sheet No. 21.

benchmarks the cost of base load purchases against the average of the Inside FERC – Gas Market Report first-of-the-month posting for the area index associated with the delivered supply and the NYMEX Settled Closing Price.[7] GAIFSL benchmarks the cost of swing load gas purchases against the mid-point *Gas Daily* posting associated with the supply area in which the swing load purchase is made.[8]

With respect to how the GAIFAM portion of the GAIF is calculated, Atmos' tariff states that the GAIFAM:

> [R]epresents the Gas Acquisition Index Factor for Asset Management, representing the portion of fixed discounts provided by the supplier for asset management rights, if any, not directly tied to per unit natural gas purchases.[9]

The GAIFAM was approved in Case No. 2005-00321 to allow the inclusion of gas cost savings represented by a fixed annual discount that could be provided by the winning bidder for Atmos' asset management contract. The savings in this instance would take the place of savings calculated using comparison of actual to benchmarked gas cost. The inclusion of the GAIFAM was requested by Atmos to give prospective asset management bidders more options in constructing their bids in response to Atmos' Requests for Proposal.[10]

Variances between Atmos' actual costs and the benchmarks are shared between shareholders and ratepayers on a sliding scale consisting of two bands. The first band

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[7] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 22.

[8] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 23 – P.S.C. KY No. 2, First Revised Sheet No. 24.

[9] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 19.

[10] Case No. 2005-00321, *Modification of Gas Cost Adjustment to Incorporate Performance Based Ratemaking Mechanism* (PBR) (Ky. PSC Feb. 8, 2006), Order 2–5.

covers variances ranging from 0 to 2 percent of Atmos' Total Actual Gas Supply Costs, as defined in the tariff, and is shared 70 percent to ratepayers and 30 percent to shareholders. The second band covers variances greater than 2 percent and is shared 50/50 between ratepayers and shareholders.[11]

Atmos asserted that its PBR mechanism provides a mix of incentives and penalties that encourage it to test new ways to purchase gas supplies and to negotiate transportation contracts in order to generate shared savings.[12] Specifically, Atmos stated that the PBR mechanism induced it to develop a contract model and request for proposal (RFP) process that it contended results in significantly discounted bids for commodity gas.[13] Atmos similarly indicated that the PBR mechanism encouraged it to generate pipeline demand savings through the receipt of segmented demand from another Atmos Division and to aggressively use alternative pipeline suppliers as a bargaining tool to negotiate meaningful discounts in transportation contracts.[14]

Atmos reported PBR savings of $28,267,062 in PBR years 16/17 through 19/20, which represented 9.1 percent of its total gas supply cost of $311,904,506 during those periods.[15] Atmos stated that the PBR benchmarks represent the reasonable and prudent

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[11] Atmos' Gas Tariff, P.S.C. KY No. 2, First Revised Sheet No. 29.

[12] Atmos PBR Report (filed Aug. 31, 2020) at 6–7; *see also* Atmos PBR Report at 4 (noting that the value inherent in Atmos' innovative request for proposal process, which it ties to the PBR mechanism, was exhibited through the receipt of significantly discounted bids for commodity gas).

[13] Atmos PBR Report at 2–4.

[14] Atmos PBR Report at 5–6.

[15] Atmos' Response to the Attorney General's First Request for Information (filed Nov. 13, 2020), Item 2; *see also* Atmos' PBR Report at Exhibit A (showing a breakdown of the PBR savings).

cost of gas.[16] Atmos indicated that the PBR savings are evidence that the actions it was induced to take by the PBR mechanism resulted in lower gas costs for customers.[17] Atmos requested that its PBR mechanism be extended for a period of five years without modification through June 1, 2026.[18]

The Attorney General argued that the Commission should modify the extent to which variations between actual and benchmark costs are shared under Atmos' PBR mechanism as it did for the PBR mechanism of Louisville Gas and Electric (LG&E) in Case No. 2019-00437.[19] Specifically, the Attorney General noted that the Commission modified LG&E's PBR mechanism based on LG&E's historical variances between benchmark and actual gas costs such that variances between 0 and 4.6 percent of actual gas costs were shared 70 percent to customers and 30 percent to shareholders and variances greater than 4.6 percent were shared 50/50 between ratepayers and shareholders. The Attorney General noted that in the PBR years ending 2017 through 2020 that Atmos' PBR savings of about $28,267,062 represented about 9.1 percent of its total actual gas costs of $311,904,506. The Attorney General argued that the sharing band for Atmos' PBR mechanism should be adjusted consistent with LG&E's PBR mechanism such that variances between 0 and 9.1 percent of actual gas costs are shared

[16] Hearing Video Transcript of the Jan. 27, 2022 Hearing at 09:35:35-09:36:05; *see also* Atmos' Response to Commission Staff's First Request of Information (Staff's First Request) (filed Nov. 13, 2020), Item 1.

[17] Atmos PBR Report at 6-7; *See also* Jan. 27, 2022 H.V.T at 9:35:35-09:36:05.

[18] Motion to Modify and Extend Performance Based Ratemaking Mechanism at pg. 2; *see also* Initial Post-Hearing Brief of Atmos Energy Corporation (filed Feb. 18, 2022) (arguing that the PBR mechanism should be extended without modification).

[19] Attorney General's Brief (filed Mar. 21, 2021) at 1–6, *citing* Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order.

70 percent to customers and 30 percent to shareholders and variances greater than 9.1 percent were shared 50/50 between ratepayers and shareholders.[20]

DISCUSSION

Generally, cost-based rates for investor-owned utilities are set at a level to allow the utility to recover its reasonable expenses and provide its shareholders an opportunity to earn a fair return on invested capital.[21] The LDCs' purchased gas adjustment mechanisms provide for full recovery of the actual cost of gas, with the LDC experiencing no risk for gas costs, retaining no profit and sustaining no financial losses on gas purchase transactions. The significance of Atmos' PBR mechanism, like those of the two other LDCs with such mechanisms, is that it allows Atmos to recover from its customers not only the actual gas costs incurred, but also a portion of calculated savings if gas costs are lower than defined benchmarks. It likewise requires a utility to return to its customers a portion of calculated losses if gas costs exceed the benchmarks. The ultimate goal of the PBR mechanism is to reduce the overall rates paid by Atmos' customers, while maintaining supply reliability, by incentivizing Atmos to lower the gas costs that are passed on to customers.[22]

If the PBR mechanism does not result in lower customer costs than would have been paid in the absence of the PBR mechanism, then the PBR mechanism would not

[20] Attorney General's Brief at 1–6.

[21] Case No. 2017-00481, *An Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation, Delta Natural Gas Company, Inc., Columbia Gas of Kentucky, Inc., Kentucky-American Water Company, and Water Service Corporation of Kentucky* (Ky. PSC Dec. 27, 2017), Order at 1–2.

[22] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of Its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order at 8.

serve its intended purpose and, therefore, would not be justified. Further, using the PBR mechanism to share savings that Atmos would have realized in the absence of the PBR mechanism would not be justified by the purpose of the mechanism. In fact, even savings actually arising from the PBR mechanism should only be shared with the utility to the extent necessary to incent the desired behavior. Additional sharing of gas cost savings would not serve the purpose of the PBR mechanism and would not be reasonable.

Atmos argued that the PBR mechanism has incentives and penalties that encourage it to generate gas cost savings and that its PBR savings demonstrate that it actually has generated savings as compared to the market. The Commission agrees that the ability to share in the PBR savings provides an incentive for Atmos to generate savings as compared to benchmarks and that Atmos has been able to beat prices paid by others for both gas and transportation services. Thus, there is some evidence to support the argument that Atmos' PBR mechanism actually results in savings for customers.

However, Atmos, like the other LDCs, has trouble establishing whether and the extent to which the incentives offered by the PBR mechanism actually result in the PBR savings recorded. Certain savings likely arise from a utility's position in the market, such as its ability to obtain multiple bids for large, long-term gas supply contracts at indexed prices below the first of the month prices or its ability to use storage assets funded by customers to obtain gas when prices are more favorable. A utility would also have at least some incentive to take advantage of opportunities in the market to reduce gas costs below benchmark prices even if the PBR mechanism were eliminated, because the Commission has the authority to review and disallow gas costs that are found to be unreasonable. Further, even if Atmos' PBR mechanism encourages cost saving behavior, the PBR mechanism would only serve its purpose of reducing customer costs if the amount of the actual savings for customers generated by the change in behavior exceeded Atmos' share of any savings that preexisted the PBR mechanism.[23] Thus, the fact that the PBR mechanism provides an incentive and Atmos does obtain gas and transportation services below costs paid by others does not necessarily establish that the PBR mechanism results in savings for customers.

In fact, there is evidence that the savings from Atmos' GAIF component of the PBR mechanism arises, at least in part, from Atmos' ability to leverage its position in the market to obtain gas at costs below benchmark prices. Specifically, Atmos generally enters into three and five-year competitively bid contracts with asset managers in which Atmos assigns all of its transportation and pipeline storage capacity for a particular pipeline to an asset manager and the asset manager provides Atmos' entire firm gas requirement from that pipeline for the term of the contract at a rate indexed to an average of the NYMEX and certain *Inside FERC* prices.[24] Atmos indicated that the value in these contracts to potential suppliers, which is generally reflected as discounted rates, is their assurance "of the opportunity to leverage Atmos' large, firm market for three to five years plus the additional opportunity to leverage Atmos' substantial transportation capacity and

[23] *See, e.g.* Case No. 2020-00378, *Electronic Application of Columbia Gas of Kentucky, Inc. to Extend its Gas Cost Incentive Adjustment Performance Based Ratemaking Mechanism* (Ky. PSC Jun. 15, 2022), Order at 8–9 (discussing how sharing savings that preexisted the PBR mechanism could raise customer costs if it exceeded customer savings generated by the mechanism).

[24] Atmos PBR Report at 3–4.

storage assets," which Atmos stated potential suppliers view as a "value-added" feature that encourages an additional level of discounting.[25]

Atmos argues that its contract model and RFP were induced by the PBR mechanism. However, the PBR mechanism did not create the market conditions that Atmos acknowledged it leverages to obtain gas at discounted rates. Even if the PBR mechanism encouraged it to tweak certain terms in its RFP and contract model, Atmos could engage in competitive bidding of long-term gas supply contracts, as it has done for years,[26] in the absence of the PBR mechanism, or could otherwise use its market position to obtain favorable gas prices as compared to others in the market in the absence of the PBR mechanism.

The fact that Atmos' position in the market, as distinguished from the PBR mechanism, generates savings is further supported by the performance of Atmos' PBR mechanism. Specifically, Atmos' actual cost of gas has been lower than benchmark prices, which Atmos contends represent the reasonable prudent cost of gas, in each month since its PBR mechanism was adopted in 1998.[27] It is highly unlikely that any incentive or potential penalty could induce a company to outperform the market in every month for over 20 years, since nearly every person trading in any market has at least some profit motive and fear of loss to induce their actions. A more likely explanation is simply that Atmos' position in the marketplace gave it advantages, which it acknowledged,

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[25] Atmos PBR Report at 4.

[26] *See* Case No. 1999-00447, *A Formal Review of Western Kentucky Gas Company's Decision to Terminate a Natural Gas Sales, Transportation and Storage Agreement with Noram Energy Services, Inc. and Enter Into A Natural Gas Sales, Transpiration and Storage Agreement with Woodward Marketing, LLC* (Ky. PSC Nov. 5, 1999), Order (discussing a long term gas supply contract Atmos' predecessor entered into when the PBR mechanism was implemented).

[27] Atmos' Response to Staff's First Request, Item 4(d).

as compared to others. Thus, while the PBR mechanism may have encouraged Atmos to take better advantage of its position in the market, the evidence indicates that the PBR mechanism is not responsible for all of Atmos' performance as compared to benchmarks and that at least a portion of the savings likely proceeded the PBR mechanism and would continue without it.

Despite weaknesses in Atmos' evidence as to the necessity of the PBR mechanism in generating gas cost savings, the Commission does not believe that it would be prudent to simply eliminate Atmos' PBR mechanism in its entirety at this time due to potential unforeseen effects on customer costs.[28] However, as previously discussed, Atmos has failed to establish that all of the savings shared through the PBR mechanism arose from the mechanism or that the extent of the sharing in the current PBR mechanism is necessary to serve the purpose of the PBR mechanism. Thus, the Commission finds that the PBR mechanism should be extended but that savings shared with Atmos through the mechanism should be reduced by adjusting the sharing bands.

Without any studies or analyses of the specific effects of PBR mechanisms on cost saving behavior,[29] it is difficult to establish the extent to which savings should be shared to serve the purpose of the mechanism. However, the Commission believes that the Attorney General's suggestion that the sharing band be adjusted based on the extent to

[28] The Commission recognizes that establishing whether and the extent to which a particular incentive influences behavior is not an easy task. Further, the Commission's ability to encourage lower costs in the absence of the PBR mechanism, through the threat of disallowing unreasonable costs, is limited by the number and complexity of gas procurement transactions and legal restrictions on its ability to disallow FERC approved costs. Thus, simply eliminating the incentives offered by the PBR mechanism in their entirety could unintentionally increase the costs passed on to customers.

[29] *See* Atmos' Response to Commission Staff's Post Hearing Request for Information (filed Feb. 16, 2022), Item 1 ("[T]he Company is not aware of any 'economic or scientific studies' that support the contention that adopting a Performance Based Rate (PBR) mechanism reduces gas costs for customers of local gas distribution companies.").

which past PBR savings compared to a utility's total gas supply costs, as in Case No. 2019-00437,[30] is reasonable, except that the Commission will include Atmos' PBR savings and gas supply costs from the 20/21 PBR year. Atmos' total savings represented 9.4 percent of its total gas supply cost in PBR years 16/17 through 20/21.[31] Thus, the Commission finds that the sharing band of Atmos' PBR mechanism shall be modified from the date of this Order such that variances ranging from 0 to 9.4 percent of Atmos' actual gas costs will be shared 70 percent to ratepayers and 30 percent to shareholders and variances greater than 9.4 percent will be shared 50/50 between ratepayers and shareholders.

With that modification, Atmos will continue to receive at least 30 percent of PBR savings, which is more of an incentive than it receives in many other states,[32] to encourage savings behavior and will have additional incentives to further improve gas cost savings beyond current levels. More importantly, this adjustment to the sharing band should also allow the Commission to monitor the effects, if any, of reducing the incentives offered under the mechanism without risking unforeseen consequences of eliminating the PBR mechanism outright.

The Commission further finds that Atmos' PBR mechanism should only be extended through May 31, 2025 for the reasons discussed above and because the Commission wants to more closely follow the impact of the reduced incentives. When

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[30] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order at 7.

[31] *See* Atmos' Report of the Performance of its PBR Mechanism from June 2020 through May 2021 (filed Aug. 25, 2021).

[32] *See* Atmos' Response to Staff's First Request, Item 11; Atmos' Response to Commission Staff's Second Request of Information (filed Dec. 18, 2020), Item 5.

the mechanism is next reviewed, the Commission will consider further reducing the amounts shared, modifying the benchmarks, or eliminating the PBR mechanism entirely, among other things.

The Commission last notes that Atmos has continued to apply its PBR mechanism without modification during the pendency of this matter. In every recent case reviewing other utilities with PBR mechanisms, the Commission has explicitly stated in the procedural order that the utility may continue applying its PBR mechanism during the pendency of the review and that was the intent in this matter. However, as noted by Atmos in Case No. 2021-00430,[33] the scheduling order in this matter did not include a specific statement that Atmos could continue to apply its PBR mechanism without modification during the pendency of this review, which created confusion regarding whether Atmos could continue to do so.

In Case No. 2015-00298, the Commission entered an order approving proposed modifications to Atmos' PBR mechanism and extending the PBR mechanism through May 31, 2021, and indicated that Atmos should file a report on the results of the PBR mechanism prior to May 31, 2021, for the purpose of determining whether the PBR mechanism should be continued, modified, or terminated.[34] However, Atmos' PBR tariff does not include explicit language indicating its term or expiration. More importantly, the Commission entered several orders during the pendency of this case approving Atmos' Gas Cost Adjustment rates reflecting the effects of PBR savings and expense without

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[33] Case No. 2021-00430, *Request of Atmos Energy Corporation for Modification and Extension of its Gas Cost Adjustment Performance Based Ratemaking mechanism*, Petition for Clarification (filed Nov. 18. 2021).

[34] Case No. 2015-00298, *Request of Atmos Energy Corporation for Modification and Extension of its Gas Cost Adjustment Performance Based Ratemaking Mechanism* (Ky. PSC Mar. 31, 2016), Order.

modification to the PBR mechanism.[35] Thus, the Commission finds that the PBR mechanism continued to apply without modification during the pendency of this matter until the mechanism was modified by this order. However, to avoid such confusion in the future, the Commission finds that Atmos' tariff should be modified to explicitly indicate the date that the approved PBR mechanism expires. This will necessitate Atmos filing a tariff modifying the term as part of the next review in order to extend the mechanism regardless of whether Atmos proposes any other modifications to its PBR mechanism.

IT IS THEREFORE ORDERED that:

1. Atmos' proposal to extend the PBR mechanism without modification is denied.

2. The current gas cost sharing calculation shall be modified as required herein, so that variances from 0 to 9.4 percent of Atmos' actual gas costs are shared 70 percent to ratepayers and 30 percent to shareholders, with sharing thereafter allocated 50/50 between Atmos and its customers.

3. Atmos' PBR tariff shall be modified to explicitly state the date the PBR mechanism approved and extended herein expires.

4. Atmos' PBR mechanism, with the modifications required herein, is approved and effective on the date of this order through May 31, 2025.

5. Atmos shall file annual reports of its activity under the extended PBR including the same information as contained in the report filed in this proceeding. These reports shall be filed by August 31 of each calendar year, commencing in 2022.

[35] *See* Case No. 2021-00142, *Electronic Purchased Gas Adjustment Filing of Atmos Energy Corporation* (Ky. PSC Apr. 26, 2021), Order; Case No. 2021-0250, *Electronic Purchased Gas Adjustment Filing of Atmos Energy Corporation* (Ky. PSC July 19, 2021), Order; Case No. 2022-00033, *Electronic Purchased Gas Adjustment Filing of Atmos Energy Corporation* (Ky. PSC Feb. 28, 2022), Order.

6. Within 60 days after May 31, 2024, Atmos shall file an evaluation report on the results of the PBR mechanism for the PBR years ending in 2021 through 2024. This report shall be considered in any proceeding established to continue, modify, or terminate the PBR mechanism.

7. Within 20 days of the date of this Order, Atmos shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the PBR tariff revision approved herein and reflecting that they were approved pursuant to this Order.

8. All documents filed in the future pursuant to ordering paragraph 5 herein shall reference this case number and shall be retained in the utility's general correspondence file.

9. This case is closed and removed from the Commission's docket.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ENTERED

JUN 20 2022 bsb

KENTUCKY PUBLIC SERVICE COMMISSION

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